No. 15340

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ELGIN R. PARKER and FLO PARKER,

Appellants,

vs.

HARRY C. WESTOVER, individually and as Former Collector of Internal Revenue for the Sixth District of California,

Appellee.

ELGIN R. PARKER and FLO PARKER,

Appellants,

vs.

R. A. RIDDELL, District Director of Internal Revenue, Los Angeles, California,

Appellee.

On Appeal From the Judgments of the United States District Court for the Southern District of California.

REPLY BRIEF FOR APPELLANTS.

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ARGUMENT.

I.

The District Court's Findings Constitute Mere Fiating.

Appellants' opening brief demonstrates that the real views of the District Court were completely different from the formal findings he signed at the instance of the Appellees.

II.
Vital Services Can No Longer Be Argued as a Prerequisite to Good Faith.

The Appellees argue on pages 12 and 13 of their brief that the record amply supports the District Court's findings and conclusions that the parties did not intend to join together in the present conduct of an enterprise and that such factual conclusion may not be disturbed upon appeal unless clearly erroneous.

When the facts in the case at bar and the law applicable to the case are considered, it will be seen that the court below simply made statements which, if considered as fact finding, were mere fiating, and if conclusions of law, were completely erroneous.

On page 13 of their brief the Appellees argue that the absence of intent to make the children partners is shown by the fact that none of them rendered any vital services.

The Appellees also state, which is a fact, that Flo Parker never contributed any services, yet they have recognized her as a partner throughout.

This Court, in *Pike v. United States,* 231 F. 2d 688, 693, said:

> "While the record fails to show any such management activity on her (the Trustee's) part, either individually or as Trustee, in the operations of this partnership, yet, as we said in Snyder v. Westover, supra, 'the absence of services is not determinative'."

III.

Original Capital Can No Longer Be Argued as a Prerequisite of Good Faith.

On pages 14 and 15 of their briefs the Appellees argue that there was no contribution of capital of which the children were the true owners.

Appellees state that Elgin R. Parker started with "little capital" and that the capital invested in the business October 31, 1943 was $193,000. Actually, nowhere in the record is it stated that Elgin R. Parker started business in 1938 with "little capital". He said that he bought the business with savings, a gift from a relative, and on time. He did not say that he did not use borrowed capital at that time. On page 79 of the record he stated that the business did not borrow any money in 1943, 1944 or 1945, other than, of course, current liabilities. Plaintiff's Exhibit No. 58 [R. 164] shows that as of October 31, 1943, the current liabilities were $113,500, so that the total capital involved was $311,578.20 rather than $193,000.

In *Pike v. United States, supra,* the lower court found there also that the "income was all attributable to the services of the plaintiff, Thomas P. Pike, and that neither the wife nor the children contributed capital or services for the production of income". The court, at page 693, said:

> "The importance of capital in the accumulation of earnings of the partnership is plain when it is noted that as appears from the pre-trial order the overhead costs chargeable to Pike & Associates alone in the year of 1945 amounted to $22,686.00. In some months the cost of sales for the month ran as high as $100,000. The exhibits show that at the end of

the fiscal year ending January 31, 1945 the partnership had $173,000 outstanding in accounts receivable. It was testified that this was because of the lag in collecting for work done."

Even at November 1, 1943, the Southern Heater Company had cash on hand of $48,000, accounts receivable $64,000, inventories $83,000, land, building, machinery, equipment, shop tools, dies, furniture and fixtures and delivery equipment $103,000, other assets $12,000, or a total of $311,000. It is obvious that no manufacturing business can operate without having equipment and a place in which to work, money to invest in inventories, money to operate the business until sales proceeds can be collected, etc.

Whether these assets were purchased with invested capital or borrowed capital is in a sense immaterial, but it is obvious that capital is needed to operate a business.

Plaintiff's Exhibit No. 63 [R. 168] shows that the average iron, steel and products manufacturing corporation in the United States had a net worth of $1,831,800 in 1945 or 55% of sales. Likewise, the average nonferrous metals and products manufacturing corporation had a net worth in 1945 of $1,179,000, or 57% of sales. Southern Heater Company's 1945 net worth of $400,298, or 25% of sales, was definitely required in the business. Everyone knows that capital is required to organize and carry on business and the income of the business is attributable not only to the services of the managers and employees, but also to the capital of the company.

The entire record conclusively shows that the children were the true owners of the capital which was given to them and which was accumulated to their credit on the books of the partnership.

On pages 16 and 17 of their briefs the Appellees argue that not much credit can be given to the children's alleged gift capital.

This Court, in *Parker v. Westover,* 221 F. 2d 603, 606, in holding that the law of family partnerships had been changed since the trial for 1944, said:

> "In 1945 and 1946 *the children invested capital* in the partnership by reinvesting a large share of their profits. . . . The amendment simply means that capital contributions derived from an *inter-family gift* must now be regarded as a factor of *substantial weight* . . ." (Emphasis supplied.)

Consequently this Court does not agree with the Appellees that gift capital is given but scant weight.

The Appellees argue on pages 16 and 17 of their brief that Section 340 of the Revenue Act of 1951 is not to be considered in connection with this case for prior years.

This is the same point that the trial judge made in holding that the verdict for 1944 was *res judicata* for 1945 and 1946, but this Court, in *Parker v. Westover, supra,* page 607, overruled that point and said:

> "This amendment to the Internal Revenue Code and the Congressional Committee Reports pertaining to it should have been taken into consideration by the lower court. . . . The principles set forth therein were recognized by the Bureau of Internal Revenue, Mimeograph 6767, Cumulative Bulletin 1952-1, pages 111, 116, 117, under the heading 'Motive and Business Purpose'."

Consequently, the Appellees cannot restore the "original capital" and "vital services" arguments that were so erroneously accepted by many courts prior to the decision in *Commissioner v. Culbertson,* 337 U. S. 733.

On page 8 of their brief the Appellees argue that the retained earnings cannot be attributed to the children until it is shown that they were the real owners of the assets. In making this argument the Appellees overlooked the point that the children were bona fide partners and owners of the business assets for California law purposes. It may be that the earnings will be taxed to the parents under federal law, but nevertheless the money and assets represented by them belong to the children under California law and when left in the business constitute original capital contribution by the children.

IV.

The Children Participated in Management Through the Guardian and the Court.

On pages 18 and 19 of their brief the Appellees argue that the children had no participation in the management or control.

Here, again, the Appellees and the lower court ignored the pronouncements of this Court as to the effect of the gifts to the children, the appointment of a guardian, the supervision of the guardian by the Superior Court and the law of fiduciary relationships affecting the children's property.

In *Toor v. Westover,* 200 F. 2d 713, 715, this Court, in discussing the lower court's statement that the transfer of part of the business assets to the Trustee made no change in the control of the business, said:

> "We are unable to agree that the creation of the limited partnership made no change whatever in the control exercised by appellant over the business. We believe there is a basic difference between control exercised with unlimited discretion solely for one's

> personal benefit and control exercised only in a fiduciary capacity as a general partner in a limited partnership. See California Code, Sec. 15,509; 20 Cal. Jur., Partnerships, Section 44. This principle has now been recognized by the Treasury Department, Mimeograph 6767, 1952-1 Cumulative Bulletin 111 . . ."

When the District Court in the case at bar held that Elgin R. Parker continued to exercise sole control over the operation of Southern Heater Company, the court was violating the fundamental principle that the decision of a Circuit Court is binding upon the District Courts in the circuit. See *E. Edelman & Co. v. Triple A Specialty Company,* 88 F. 2d 852, 853 (C. A. 7, 1937), certiorari denied, 300 U. S. 680; *Palmer v. Bender,* 49 F. 2d 316, 324, affirmed, 57 F. 2d 32, affirmed, 287 U. S. 551; *Parker v. United States,* 125 Fed. Supp. 731, 733; *Morrone v. Southern Pacific Co.,* 72 Fed. Supp. 285; *In re Imperial Irrigation District,* 38 Fed. Supp. 770, 773, affirmed; *Wells Fargo Bank and Trust Company v. Imperial Irrigation District,* 136 F. 2d 539, certiorari denied, 321 U. S. 787. In fact, throughout the District Court's decision it is obvious that it has completely ignored and disregarded the several recent decisions of this Court on family partnership matters, including the decision of this Court on the *res judicata* point that there had been a change in the climate relative to family partnerships. See its decision [R. 31 to 33] and consider the pronouncements of this Court in *Toor v. Westover,* 200 F. 2d 713, *Snyder v. Westover,* 217 F. 2d 928, *Commissioner v. Edward D. Sultan,* 210 F. 2d 652, *Commissioner v. Thomas H. Brodhead,* 210 F. 2d 652, *Commissioner v. Roy Eaton,* 210 F. 2d 753, *Pike v. United States,* 221 F. 2d 603.

V.

The Children Enjoyed Their Income and Capital.

On page 20 of their brief the Appellees argue that unless Parker instituted proceedings, the children could neither withdraw from the partnership nor receive actual distributions of income from the business.

This is contrary to the law, since the Superior Court supervising the guardian could have ordered distributions or dissolution of the partnership even though the guardian did not acquiesce therein.

On page 20 of this brief the Appellees further argue that the children did not enjoy the fruits of their partnership. The facts show that in 1948 the partnership was dissolved and the partnership assets were completely distributed to the guardianships and the adult partners. The facts further show that since that time two of the children have become of age and have received their shares of the assets outright, free of their parents' control. The other estates are being held by the guardian under bond subject to supervision of the court and will be distributed when the wards become of age. The Appellees say on page 20 that the Parkers remained the substantial owners of the interests purportedly given away and cite *Toor v. Westover,* 200 F. 2d 213. That decision says that holding property in a fiduciary capacity is far different from holding it for one's self.

On page 20 of their brief Appellees claim that there was no change in the economic condition of the parents. The Commissioner did not see the matter this way when he accepted the gift taxes made by the parents on the 1943 transfers. In fact he increased them by determining that the business had a valuable good will and that the parents had given the children interests in the good will.

VI.

The Usefulness of the Children's Capital in the Business Is Adequate Business Purpose.

On page 24 of their brief, Appellees argue that there was no business purpose for making the gifts to the children and making them partners and hence the business purpose tests as set forth in Mimeograph 6767 are not satisfied.

The point that the children became general partners and hence their interests would be subject to the risks of the business, is fully answered in the Appellants' opening brief page 15.

On page 21, of their brief, Appellees cite *Hash v. Commissioner,* 152 F. 2d 722 as authority for the proposition that the desire of inducing the children into the business is a *personal* purpose rather than a *business* purpose. That decision does not so hold. On the contrary *Nicholas v. Davis,* 204 F. 2d 200 said that the purpose of benefiting the children was "a legitimate and commendable business purpose." A close analysis of the decisions of this Court in *Pike v. United States,* 231 F. 2d 288 and *Snyder v. Westover,* 217 F. 2d 928 will show that the only purpose there was to benefit the children. Still the purposes in those cases were held to be business purposes.

On pages 21 and 22 of their brief, Appellees refer to *Smith v. Westover,* 237 F. 2d 201 as setting forth a "similar situation". But in *Smith v. Westover* the partnership agreement provided that the majority in interests should control and in case of a tie, Jack Smith, the father, should have the last word. This was true with respect to practically everything and he had the right to purchase the interests of a deceased terminating partner at book value. Therefore, when the trial court held

in the *Smith* case that the father retained control and that there was no judicial control of the interests (the father being trustee for the trust created by the wife and the wife being trustee for the trust created by the father), the findings were not in error. The same trial judge decided that case also, but distinguished it from the case at bar when on page 182 of the Record he said:

> "Each of these cases has its own peculiarities, which have to be considered. There are many elements which have developed in trial which did not exist in some of the other cases. Perhaps one of the most significant is that there is no general power such as existed in some of the others, of the managing partner to terminate the partnership or make disposition of the profits except in accordance with the general partnership agreement."

Again on page 186 of the Record, the trial judge in the case at bar said:

> "There are many elements present in some of the other cases, some of which, I, myself, have decided, which simply are not present here. One of the most significant ones is that except through failure the father had no way of milking the business, as it were, or even of exacting unreasonable compensation for his services or forcing a sale. All the conditions were equal. Whatever right he had, the others had."

In the *Smith v. Westover* case there was no judicial control but in the case at bar the lower court [R. 186] said:

> "It is true in a sense he dealt with himself, but even the probate court, exercising its advisory duties in a most cursory manner could not have allowed, under the wording of the partnership agreement,

> following the gift, any of the exploitations of the estate of the type which was present in some of the other cases."

On pages 22 and 23 of their brief, the Appellees argue that the parents had to borrow the children's tax refunds and borrow other moneys from the partnership and that this indicates that there was a tax avoidance motive. The Appellees argue that at the time of the gift and at the creation of the partnership, it was expected that if the children were not held to be taxable on their income from the partnership, they would not share in the partnership income as true owners of their capital interests in the partnership.

A similar situation was present in the case of *Pike v. United States,* 231 F. 2d 688. This Court there said the problems that such borrowings gave rise to were questions of state law. The Court said:

> "Moreover, the circumstances of this borrowing has such slight bearing upon the main question of good faith, intent and business purpose in organizing the partnership that they cannot in our opinion alter our determination of these questions."

The principle of restitution was sought to be applied in the *Parker* case wherein the parents made contingent claims against the guardianship estates for restitution of the refunds if the parents eventually lost their cases, and perhaps further equalization of the tax burden. The Parkers had no thought about this at the time the gifts were made but it eventually appeared that if they were going to have to pay income taxes on the total partnership income, there would have to be some adjustment of the distribution of that income.

The Appellees say on page 24 of their brief that Mr. Parker stated, after the Commissioner had assessed all the tax on the partnership income to him and Mrs. Parker, that if he had known that would be the eventual result he would have liquidated the partnership. The Appellees seem to think that this indicates that there was no bona fide original gift to the children.

It is obvious that with the present high tax rates, no one can pay the income tax on another's income and survive. If one of the Justices of this Court should step down and commence the practice of law, say with an adult son who was already in the practice of law and earning $25,000 per year, and they agreed to divide the earnings equally and they each thereafter earned $100,000 and the Commissioner taxed $175,000 to the father, undoubtedly the father would have to terminate the partnership, as to pay taxes on his son's income would be "insufferable and unintended and unsatisfactory and inequitable." Any one would terminate such a partnership even though it were with a child. Mr. Parker testified that the gifts were outright [R. 75], and the entire course of conduct since Oct. 31, 1943, shows that they have been so treated.

The parents made gifts to their children of interests in business assets to give them some security should the parents, through personal and outside speculations, again get into straitened circumstances. These gifts were absolute and unconditional. On such gifts, gift taxes were paid and retained. The children's assets were required in and useful to the business. The parents were adequately compensated for the services they rendered to the partnership. The children's assets and income were fully protected by the probate court supervising

the guardianships. The adult children have taken their assets into their own hands. The good faith of the partners has been established, through their conduct for fourteen years. The children really and truly owned their interests in the business, and all parties intended to operate the business together. The income from the children's assets should be taxed to them, and not to the parents.

Conclusion.

The judgments of the District Court are completely erroneous and should be reversed.

MELVIN D. WILSON,

Attorney for Appellants.

Dated: May 16, 1957.